TRIVARIATE RESEARCH

INFLATION PLAYBOOK PART 2 OF 2 – THE BENEFICIARIES OF RISING COMMODITIES

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INFLATION: PART 2 OF 2 – CAN YOU STILL OWN ENERGY & MATERIALS?

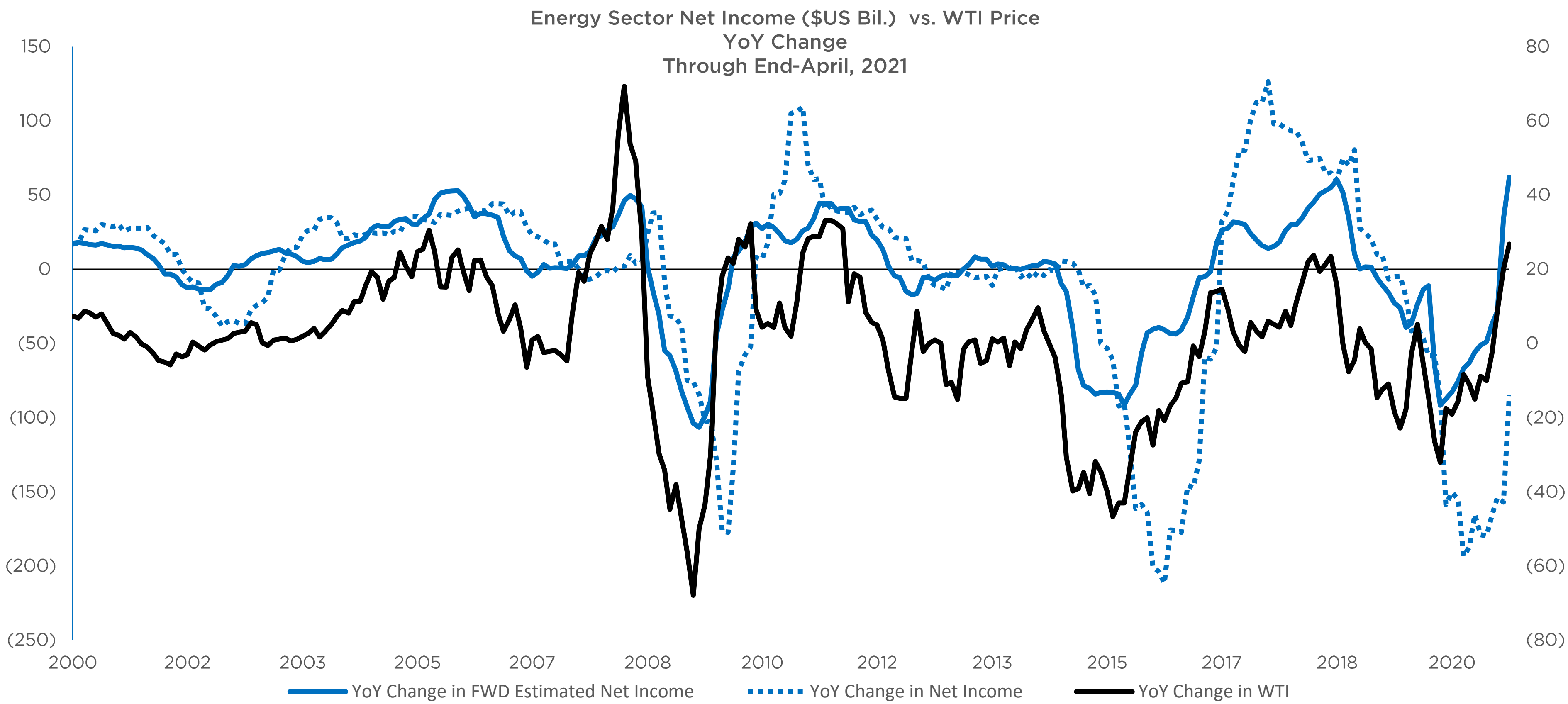
Last week in our first inflation note, we tackled the relationship between stock returns and interest rates, concluding that healthcare services and technology hardware were buys, banks should be pair-traded, and utilities should be sold. Today in our second inflation note we discuss energy and materials, which have both performed quite strongly year-to-date, and are a key investment controversy. Given that oil prices have plateaued in these last few weeks after a huge expansion, and that commodities prices have risen at historic rates, some investors think we are in the 9th inning of these trades. **Our judgment is that we are closer to the 6th inning, and that the large sell-off in energy and materials yesterday provides a good entry point to add to both groups. In short, our answer is – YES you can still own energy and materials.**

For energy, rising oil means higher earnings revisions and higher net income for the group. Earnings revisions are highly effective at picking winners from losers within the group for the 6-months following periods when oil is rising, likely meaning energy stocks beating estimates will still perform strongly. In addition, despite the strong rally, the sector is quite cheap versus history on price-to-book despite the rally, which historically was the most efficacious valuation metric for picking energy stocks.

For materials, the huge year-over-year move in commodities nearly guarantees the sector is poised to see record profitability next year, **yet valuation is at 18-year lows vs. the market excluding materials**. Revisions and valuation also work here so we offer long ideas in energy and materials, and we recommend investors own this group for inflation.

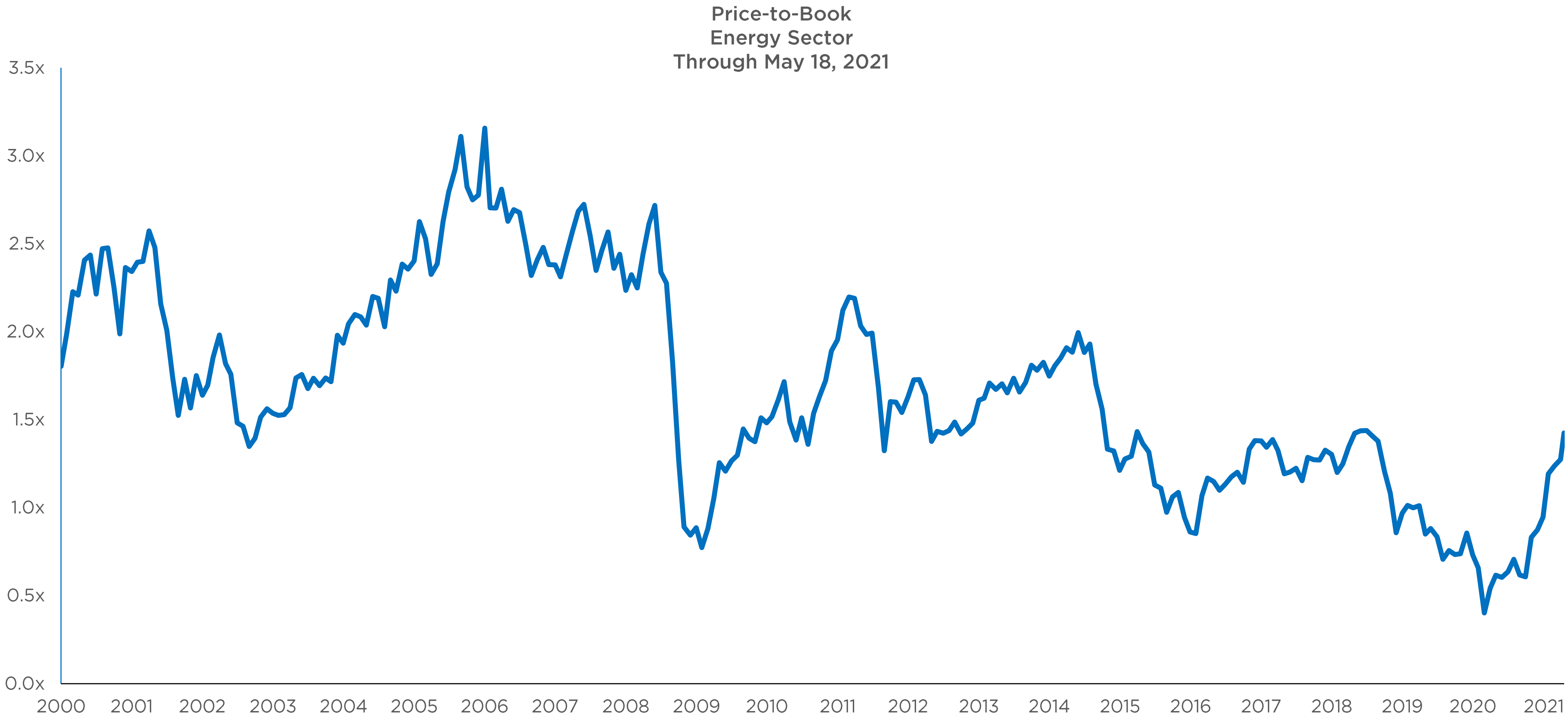
THERE IS A LAG BETWEEN OIL PRICES, ESTIMATES, AND REPORTS

For energy, oil prices are a leading indicator for net income of the energy sector. The black line below shows the change in WTI , which is typically a 3-to-6-month leading indicator for the dashed blue line, which is reported net income. The analysts typically wait until after oil lags (solid blue line), but right before the companies report earnings, so their forecasts are not particularly anticipatory



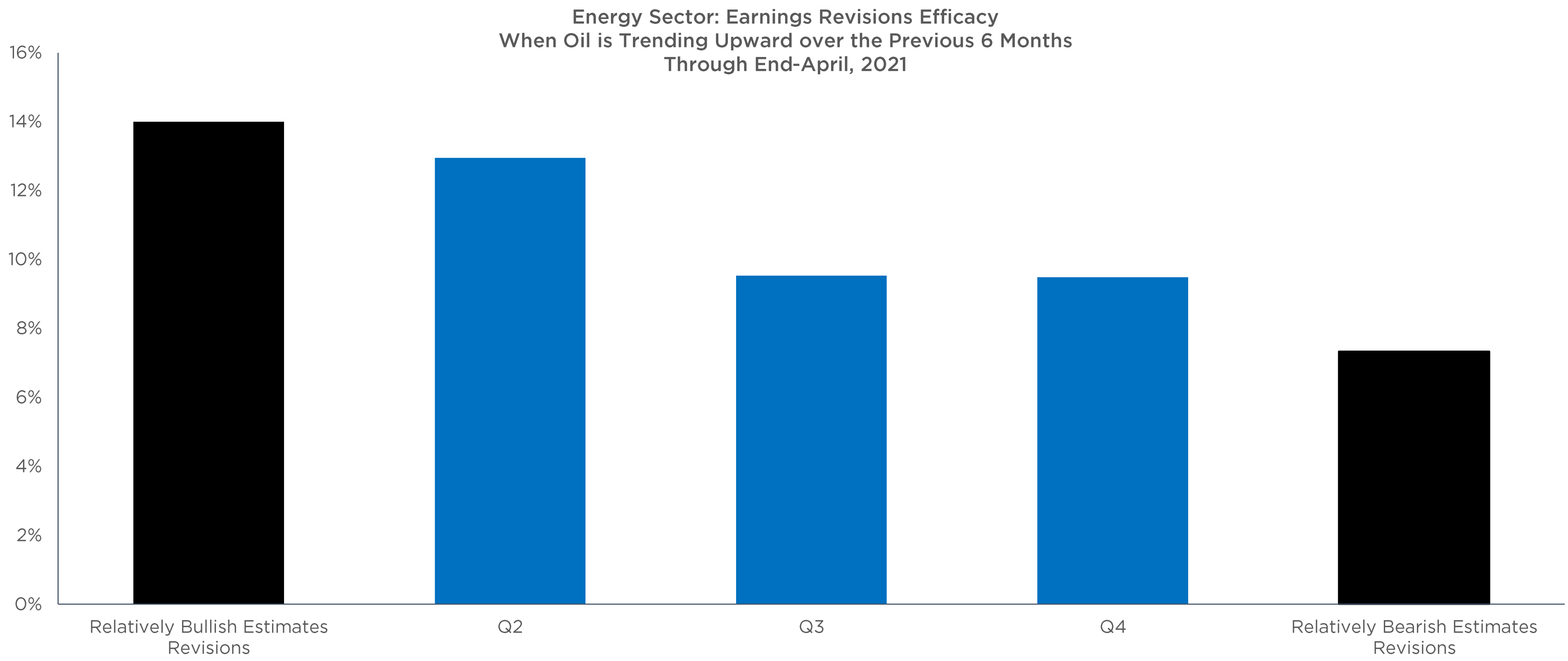
DESPITE THE RALLY, ENERGY IS STILL CHEAP

Despite the strong rally in the last six months, the valuation of the group is still quite attractive versus history, only slightly above the bear-levels of the 2016 energy crisis



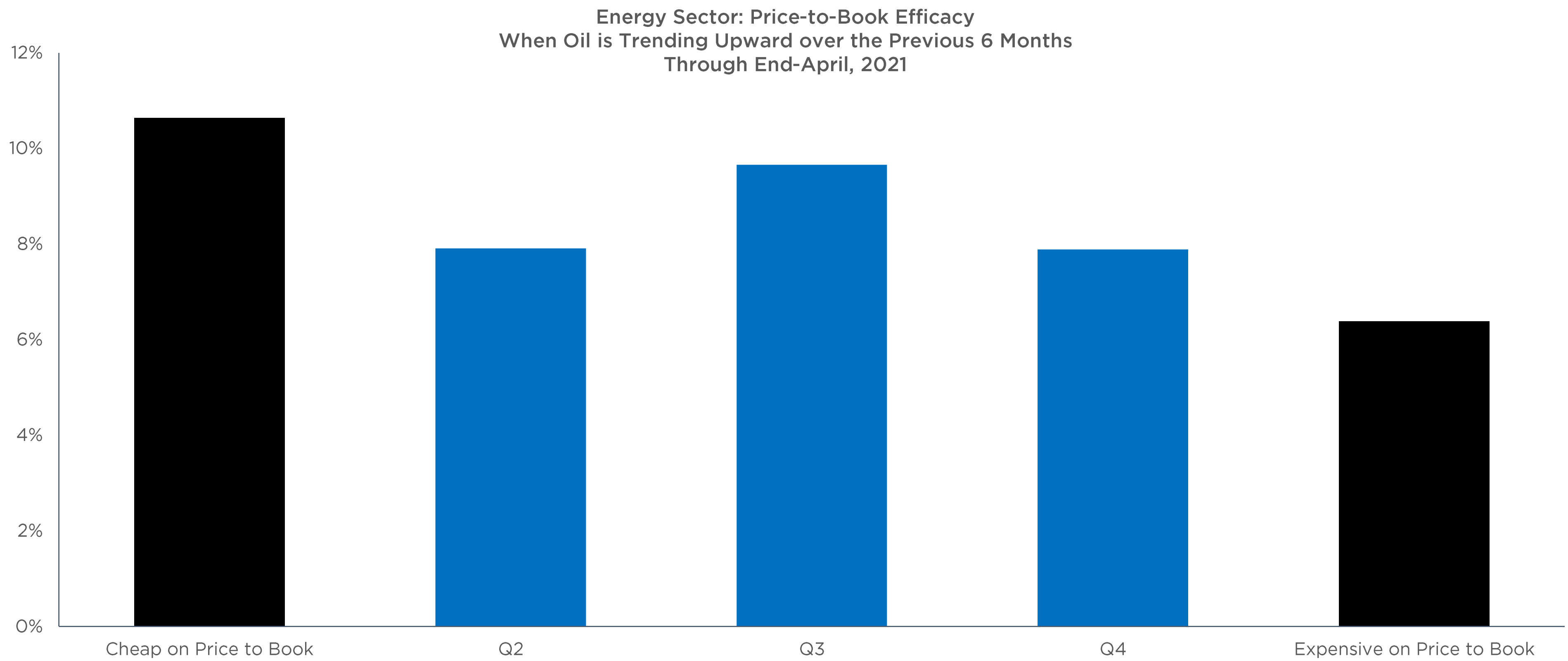
EARNINGS REVISIONS WORK IN ENERGY – STAY LONG THE WINNERS

We analyzed whether earnings revisions were efficacious at predicting subsequent energy sector returns when oil is rising. Given that stocks prices are typically anticipatory, we have received several questions about how much more energy stocks could rally. During a rising oil regime, analyst earnings revisions have historically been highly effective at picking winners from losers, with the top quintile on revisions beating the bottom quintile by approximately 7% during the average subsequent 6-month period



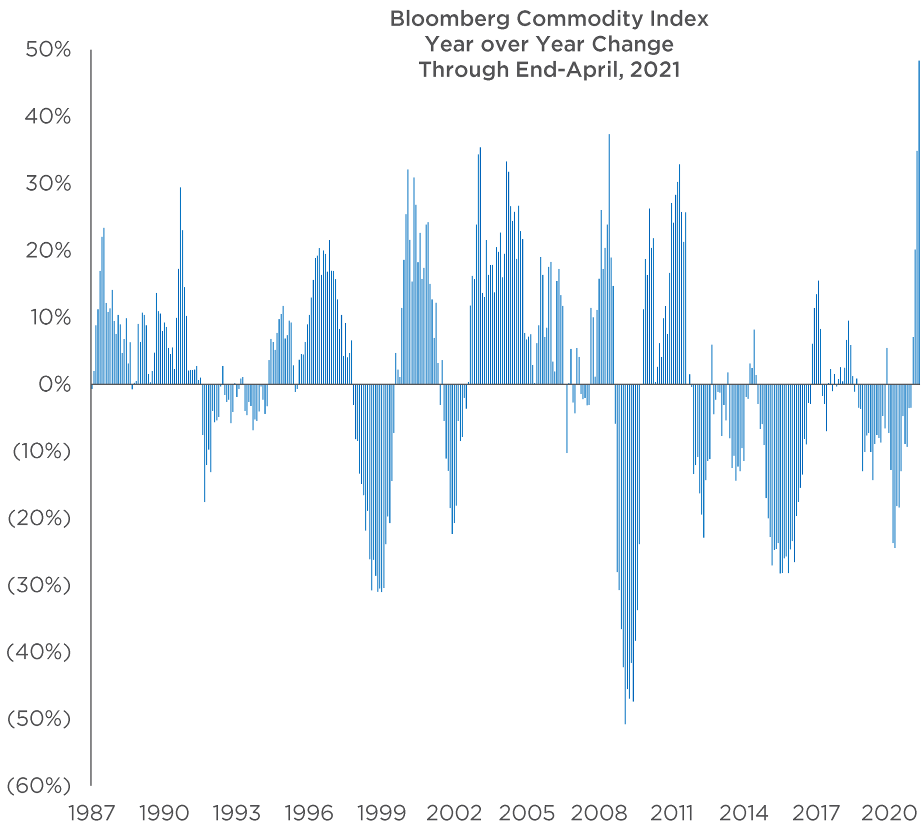
VALUATION ALSO WORKS WITHIN ENERGY WHEN OIL IS RISING

While for the broader market we do not necessarily anticipate valuation metrics to work particularly well, valuation remains highly effective at picking winners from losers within energy when oil has been rising over the previous six months. The cheapest quintile on price-to-book outperforms the most expensive quintile on price to book by approximately 500bps on average during the six-month periods following rising oil prices



COMMODITY PRICES HAVE RISEN AT HISTORIC RATES

We have all seen and read about supply chain disruptions and demand exceeding supply causing historic moves in commodity prices. Commodity prices have grown year over year by their highest in over 35 years (left chart), leaving many commodities at or near all-time highs (right chart)

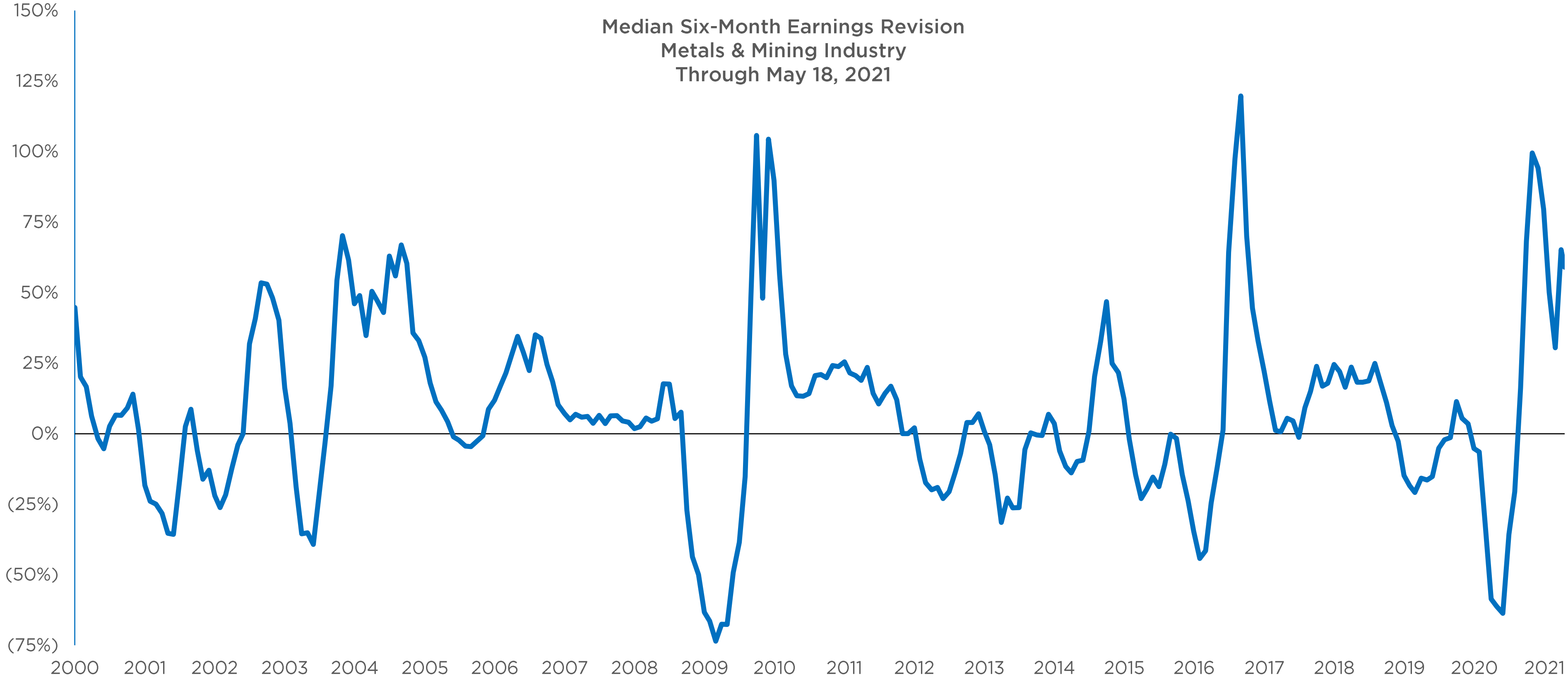


Select Commodities
Percentile of Level vs. History Since 1987
May 17, 2021

Commodity	Percentile vs. History
Copper	99.93
Lumber	99.78
Soybeans	99.21
Gold	98.92
Corn	95.32
Silver	94.42
Wheat	92.97
Aluminum	90.33

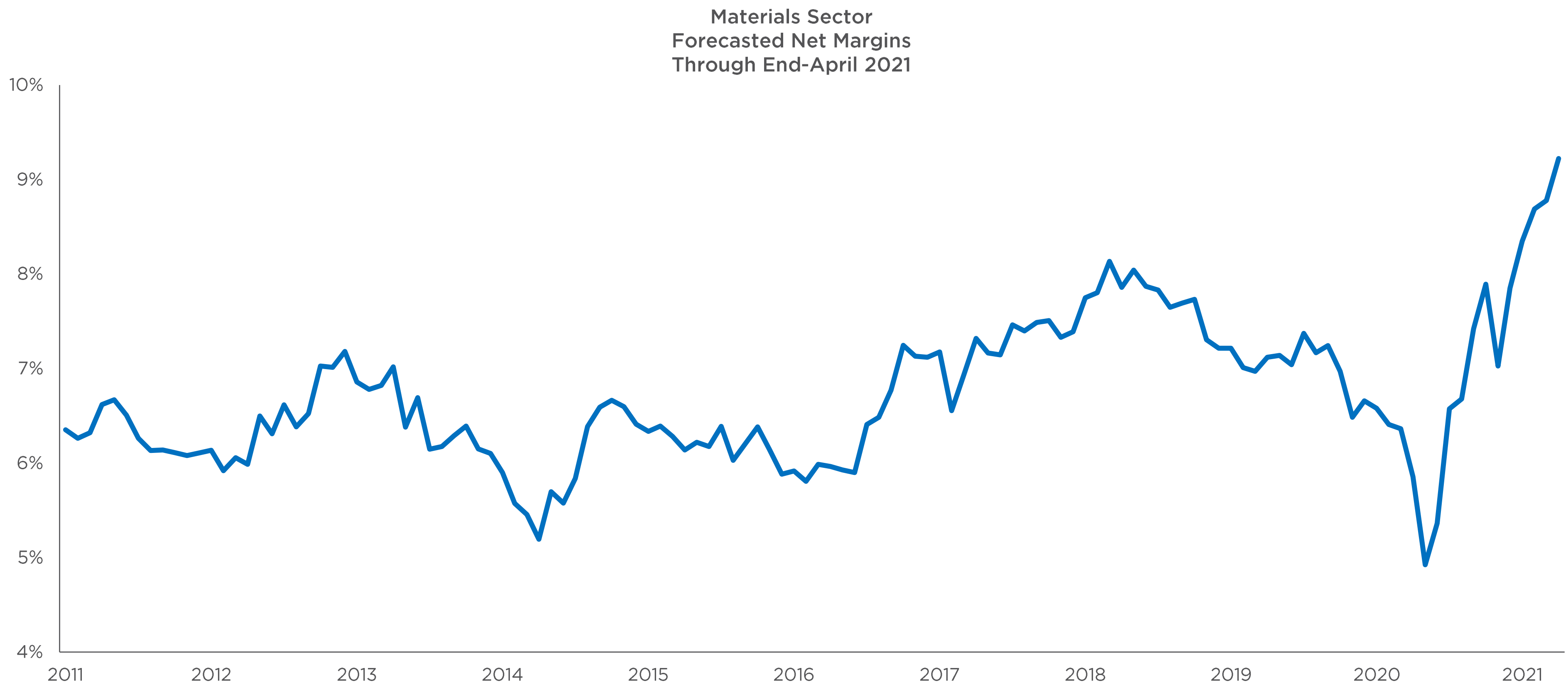
THE RESULT HAS BEEN STRONG EARNINGS REVISIONS

The result is that the companies have beat earnings by a surprisingly large amount, with metals and mining industry earnings revisions some of the largest in magnitude seen in the last twenty years



MATERIALS MAY ACHIEVE RECORD PROFITABILITY

The consensus expectations are that net margins for the material sector will achieve record highs

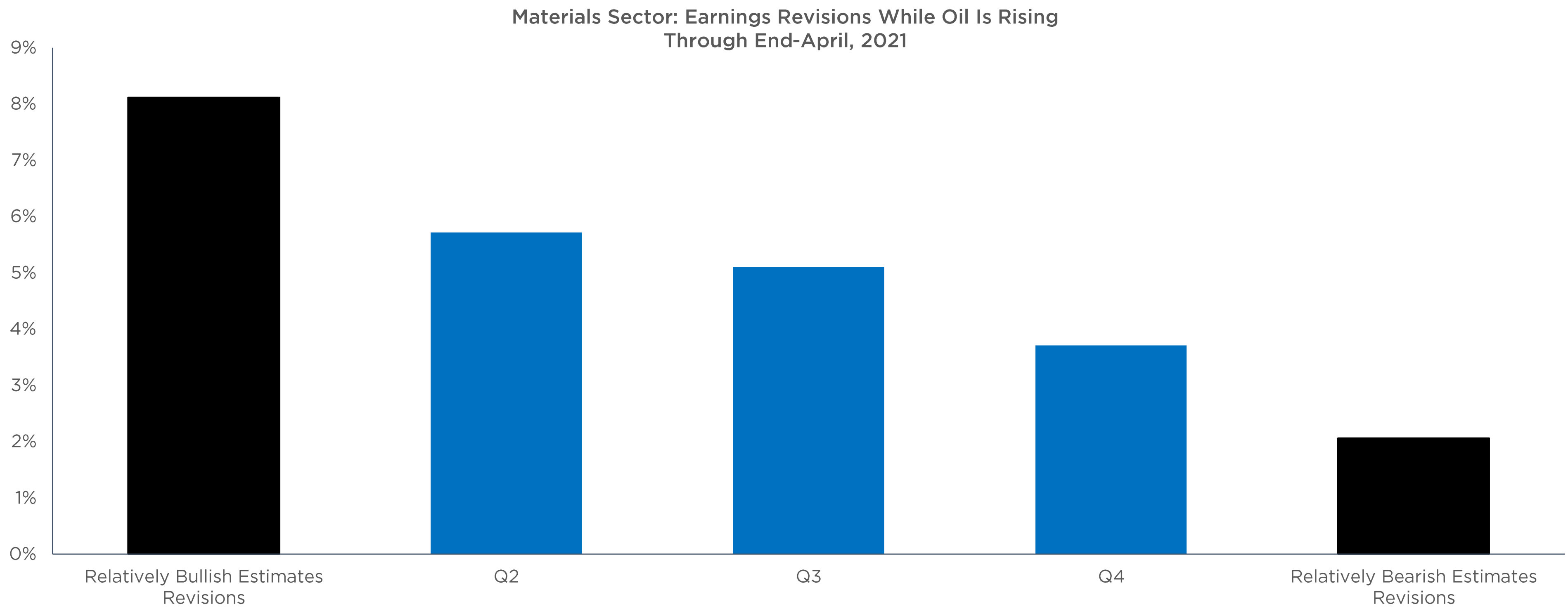


HOWEVER, THE MARKET IS SKEPTICAL THAT THIS WILL PERSIST

Our belief is that many of the companies can structurally improve cycle to cycle with the anticipated profit expansion, helping future investments and balance sheet repair. Yet, the valuation has declined on a relative to the market basis to 18-year lows despite this expected strength in profitability. We like the risk-reward of a sector with high but likely achievable near-term estimates and attractive relative valuation

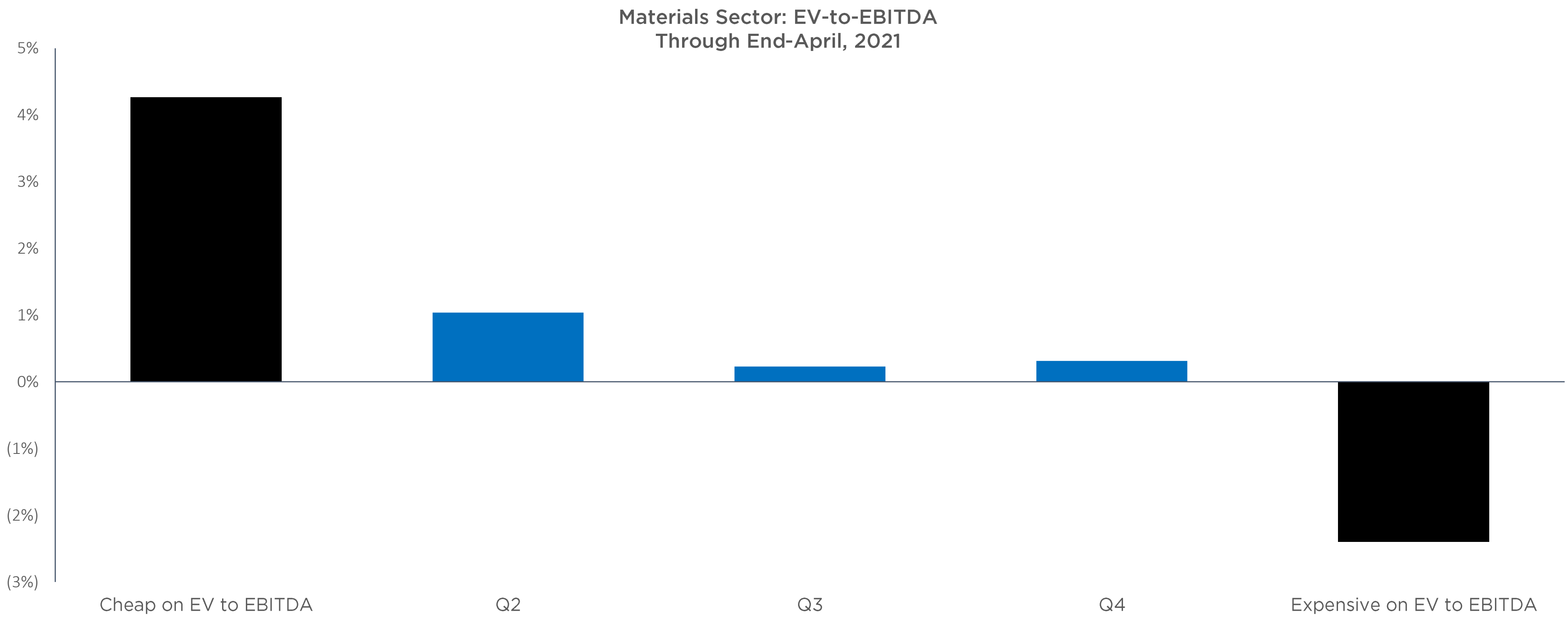
WITHIN MATERIALS, STOCKS STILL WORK AFTER UPWARD REVISIONS

As was the case in energy, materials stocks with upward analyst earnings revisions outperform those with less upward or downward revisions as oil and commodity prices rise. The top vs. bottom quintile spreads on earnings revisions average 600bps on average over the subsequent six months following rising revisions



CHEAP MATERIALS STOCKS WORK WHEN OIL IS RISING

Within the materials sector, valuation remains highly effective at picking winners from losers with the cheapest quintile on EV-to-EBITDA outperforms the most expensive by 700bps on average during the six-month periods following rising oil prices



ENERGY AND MATERIALS STOCK SCREEN

Tying it together, we are bullish on energy and materials given the combination of estimate achievability and valuation. The below screen shows stocks that are in the energy and materials sector and are in the top 25% of both valuation and earnings revisions today

Energy and Materials Sector
Top Quartile in Estimate Revisions and Valuation
May 18, 2021

Ticker	Company	Market Cap. (US$ Bil.)
NUE	Nucor Corporation	30.96
STLD	Steel Dynamics, Inc.	13.37
MRO	Marathon Oil Corporation	9.40
AA	Alcoa Corporation	7.44
LPX	Louisiana-Pacific Corporation	6..61
AR	Antero Resources Corporation	3.92
CBT	Cabot Corporation	3.53
MUR	Murphy Oil Corporation	3.24
UFS	Domtar Corporation	2.74

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